QUARTERLY LAW UPDATE

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BANKRUPTCY COURT OPINIONS

***In re Michael R. Lynch,* Chapter 7 Bankruptcy Case No. 01-21790 EEB.** The Court granted summary judgment to Plaintiff, finding that the Defendant's prior criminal conviction for theft of Plaintiff's money should be given collateral estoppel effect in finding "larceny" under Section 523(a)(4). In doing so, the Court finds that the requirement of "mutuality" of parties has been abolished in this jurisdiction, allowing collateral estoppel to be used offensively against a defendant who lost in a prior action, even though the plaintiff was not a party to the prior case. It finds that a judgment that is on appeal, but not stayed on appeal, is "final" for purposes of collateral estoppel. It finds that the federal common law definition of "larceny" does not require a finding of "fraudulent" intent, as stated by many courts, but only a finding of an intention to steal. Thus, a theft conviction, without a finding of deception or intentional misrepresentation, may be given preclusive effect in a larceny nondischargeability case.

***In re Janet L. Schafer,* Chapter 7 Bankruptcy Case No. 04-18699 EEB.** Debtor failed to notify credit union of bankruptcy filing for several days, which allowed prepetition checks to clear postpetition, all but eliminating prepetition balance in accounts. Debtor owed Credit Union for prepetition line of credit debt. On learning of bankruptcy, Credit Union froze accounts which then contained postpetition payroll deposits. Credit Union waited six weeks to seek relief from stay, while making repeated requests for reaffirmation of line of credit debt. Debtor moved for finding of stay violation. Credit Union moved for stay relief to offset account balances against line of credit debt.

The Court found that Credit Union could only setoff prepetition balance remaining in accounts, despite fact that Debtor allowed the dissipation of the Credit Union's cash collateral. It could not setoff against postpetition deposit because Section 553 limits setoffs to mutual prepetition debts. Postpetition payroll deposit created postpetition claim against Credit Union. Equitable doctrine of recoupment not available to circumvent Section 553's limitation because line of credit agreement was separate transaction from depositor's agreement. Credit Union violated stay by placing administrative freeze in effect for over six weeks, before seeking stay relief and while making repeated requests for reaffirmation. While Credit Union did not intend to violate stay, such intent is not required. An action is willful if party knew of stay and intended to take the action that violated stay. Once willful violation is established, compensatory damages are mandatory. Doctrine of unclean hands (arguably applicable due to Debtor's dissipation of Credit Union's cash collateral) does not apply to bar damages. However, Court found that Debtor must file adversary to seek damages and in that context Credit Union would not be prevented from asserting offset for postpetition claim for possible conversion of its cash collateral. Section 553 does not prevent offset of mutual postpetition claims (for stay violation and conversion).

***In re Joel P. and Dana R. Laughlin,* Chapter 7 Bankruptcy Case No. 03-15242 SBB.** A Trustee is deemed to have prematurely distributed proceeds of the estate to creditors when he does so prior to court approval of the Final Report. If he does so prior to the court approval, he runs the risk of having to recover the early distributions to creditors, or otherwise rectify the early distribution, in order to account and pay for claims "tardily filed [but] before the date on which the trustee commences distribution under [Section 726(a)(1)].

The issue before the Bankruptcy Court was whether the Trustee "commences distribution" under 11 U.S.C. § 726(a)(1) when he has filed his Final Report with the Court, mailed his Notice, and sent the dividend checks to claimants, all before the Court's approval of the Final Report. The trustee asserted that he "commenced distribution" at the time he mailed the checks. The Court concluded that most, if not all, of the reported decisions interpreting the term "commences distribution," in the context of 11 U.S.C. § 726(a)(1), hold that the trustee first commences distribution on the date the bankruptcy court approves the Final Report. The Bankruptcy Court reluctantly agreed with the seemingly uniform legal precedent on the interpretation of the term "commences distribution" and concluded that the trustee herein had not "commenced distribution" under 11 U.S.C. § 726(a)(1).

***LaFarge West, Inc., f/k/a Western Mobile Southern, Inc., d/b/a LaFarge Southern v. Patrick G. Riley and Ralph W. Walker,* Adversary Proceeding No. 03-1082 ABC**. Concrete supplier brought an adversary proceeding against the Chapter 7 debtors (who were principals of subcontractor) seeking to establish that a $192,878.48 debt arising from a breach of the Colorado mechanic's lien trust fund statute (C.R.S. § 38-22-127) was nondischargeable under 11 U.S.C. § 523(a)(4). In concluding that $160,276.50 of this debt was nondischargeable, the Court held (i) preserving mechanic's lien rights is not a requisite to a claim under the mechanic's lien trust fund statute; (ii) where a supplier has identified trust funds disbursed to a subcontractor on multiple properties, the subcontractor must account for disposition of those trust funds on a property-by-property basis or face liability to the supplier to the extent it cannot; (iii) the Colorado Supreme Court's ruling in Leonard v. McMorris, 63 P.3d 323 (Colo. 2003) does not extend to relieve corporate officers from individual liability when a corporation has breached its fiduciary duties under C.R.S. § 38-22-127, and the officers have been in a position of full control of the corporation's financial affairs.

***Stetson Ridge Associates, Ltd. and Tri-C Construction Co., Inc. v. Ralph W. Walker,* Adversary Proceeding No. 03-1317 ABC**. Owner and general contractor on an apartment project brought an adversary proceeding against the Chapter 7 debtor (who was a principal of subcontractor) seeking to establish that a debt arising from breach of the Colorado mechanic's lien trust fund statute (C.R.S. § 38-22-127) was nondischargeable under 11 U.S.C. § 523(a)(4). The Court dismissed plaintiffs' claims, holding that owners and general contractors are without standing under C.R.S. § 38-22-127. The Court declined to follow an earlier ruling of this Bankruptcy Court which had reached the opposite conclusion. In re Specialized Installers, Inc., 12 B.R. 546 (Bankr. Colo. 1981).

***Timothy Duca v. Shannon Duca,* Adversary Proceeding No. 03-2161 HRT.** This case went to trial as a § 523(a)(5) action to find a hold harmless provision in a divorce decree nondischargeable as a debt for maintenance and support. The Court found the provision to be part of the property settlement and discharged the obligation. The Court discusses the effect of the parties' pre-trial statement to set the scope of the trial and the non-admissibility of evidence going to issues not appearing in the pre-trial statement. The Court also

discusses the standards for finding a provision in a divorce decree to be support-related and the effect of language in the decree purporting to determine the nature of an obligation for purposes of Title 11.

In re Denver Community Development Credit Union; **Involuntary Chapter 11 Case No. 04-23761 HRT.** In this case, an involuntary petition was filed and later dismissed on the basis that a credit union may not be a debtor under the § 109 of the Bankruptcy Code. The successor in interest of the alleged debtor filed a motion for sanctions against both the petitioning creditor's counsel and against a board member of the petitioning creditor. The motion requested relief under both § 303(i) and under Rule 9011. Under the circumstances, the Court found that sanctions would generally be in order, but it ultimately denied the sanctions request. The denial was based on a failure of the movant's evidence as to the amount of fees and costs.

In re Barbara Jean Boan, **Chapter 7 Case No. 02-17613 SBB.** In a case of first impression, the Court concluded that 11 U.S.C. § 726(a) is an exception to the general rule under Colorado law—and common law—that a creditor may apply payments on a debt in any way it pleases.

Specifically, the Court concluded that 11 U.S.C. § 726(a)(1), (2), (3) and (4) breaks up claims into essentially two portions: (1) the portion(s) constituting compensation for an actual pecuniary loss and (2) the portion(s) constituting a penalty for wrongdoing. Consequently, where a creditor reaches a settlement with a trustee in a bankruptcy case, it must apply the sums to its claim in accordance with section 726 and not as it pleases and as allowed under state law in the absence of bankruptcy.

Bank One Delaware, NA f/k/a First USA v. Johnny D. Hamilton; **Adversary Proceeding No. 04-01560 SBB.** Plaintiff brought a complaint, generally, under 11 U.S.C. § 523(a)(2)--that is, it did not expressly set forth if it was relying on section 523(a)(2)(A), (B) or (C). Defendant brought a Motion to Dismiss and Motion for Summary Judgment noting the flaws in the complaint and seeking dismissal of the case for the reason that the transfer in question was a balance transfer from one credit card to another and that no charges were incurred in the 60 days before filing.

The Plaintiff did not respond to the Motion to Dismiss and Motion for Summary Judgment, but did file a letter with the Court indicating that a settlement may be filed in the near future. No formal request to stay these proceedings was filed, however. After the passage of over 25 days after receipt of the letter, no further pleadings were filed by the Plaintiff. In the absence of any contradictory evidence, the Court concluded that this debt did not fall into the type of debt that would not be dischargeable under 11 U.S.C. § 523(a)(2)(C) because: (1) no credit card charges were incurred in the 60 days prior to filing and (2) in accordance with In re Poor, 219 B.R. 332, 336 (Bankr.D.Me. 1998), and the facts of this case, the credit card balance transfer did not constitute a cash advance for the purpose of 11 U.S.C. § 523(a)(2)(C).

TENTH CIRCUIT OPINIONS

In re Poland, Poland v. Educational Credit Management Corporation, Equifax Accounts Receivable Corporation and TGA, Inc., **Case No. 02-3020 (10th Circuit September 7, 2004)**. The Tenth Circuit reversed a decision of the United States District Court for the District of Kansas upholding discharge of a student loan debt in a Chapter 13 bankruptcy case. The Debtor's Chapter 13 plan stated that she disputed the

validity and amount of her student loan debt, that if a claim was filed on the debt she would object, and if no timely claim was filed, "the claim shall be deemed discharged in its entirety upon completion of the Plan."

The plan was confirmed, and a claim on the student loan debt was filed one day after the claim bar date. The claim was disallowed by the bankruptcy court, which entered an order of discharge in January 1999. Educational Credit Management Corporation (ECMC) attempted to collect on the debt. The Debtor reopened the bankruptcy and filed an adversary proceeding to determine that the student loan debt had been discharged.

The bankruptcy court relied on Andersen v. UNIPAC-NEBHELP, 179 F.3d 1253 (10th Cir. 1999) in holding that the unchallenged plan and discharge order were res judicata on the issue of discharge.

In Andersen, the Chapter 13 plan included language that excepting the student loans from discharge would impose an undue hardship on the debtor and the debtor's dependents, and that confirmation of the plan constituted a finding to that effect and that the debt was dischargeable. The plan was confirmed without objection, plan payments were completed and a discharge order was entered. Thereafter, the creditor requested payment of the loan.

In Andersen, the 10th Circuit noted that a debtor was normally required to prove undue hardship in an adversary proceeding, but determined that the order confirming the Chapter 13 plan was res judicata on the issue of hardship and not subject to collateral attack.

The 10th Circuit distinguished the Poland plan on the basis that the plan made no mention of undue hardship, but only stated the fact, amount and disputed nature of the student loan debt. Because there was no finding of undue hardship in either the plan or the discharge order, the Court held that Andersen did not apply and the student loan was not discharged. The Court also noted that the proper way to discharge a student loan is to establish undue hardship in an adversary proceeding and noted the view of the panel that Andersen was wrongly decided and should be reconsidered (footnote 2).

***In re Hedged-Investments Associates, Inc.*, Case Nos. 02-1191, 02-1192 (10th Circuit August 26, 2004).** This is another decision in the bankruptcy of Hedged Investments Associates, Inc., a stock investment Ponzi scheme which collapsed in the fall of 1990. The case resolved the issue of whether a loan by The Bronze Group, Ltd. should be recharacterized as an equity investment, or whether the Bronze Group's claim should be equitably subordinated so as to be on a par with the equity investors. In holding that the loan did not meet criteria for either recharacterization from a loan to a capital contribution or equitable subordination, the 10th Circuit reviewed case law in the area.

The Court noted the important distinction between recharacterization and equitable subordination. Under either theory, the claim is subordinated as a proprietary interest and paid only after satisfying all other obligations of the corporation.

When determining whether a loan to a bankrupt debtor should be recharacterized, the court looks beyond the label given to the transaction and examines its true substance. If the loan is recharacterized, the court determines that the claim is equity and not debt, i.e. that a debt does not actually exist. The effect is subordination because the estate will repay equity only after debts are satisfied.

The doctrine of equitable subordination does not examine the substance of the transaction, but looks at the

behavior of the parties to remedy some inequity or unfairness by subordinating that creditor's right to repayment even though it is still considered debt rather than equity. If the creditor has engaged in equitable conduct, the remedy is subordination of that creditor's claim to that of another creditor to the extent necessary to offset the injury or damage to the other creditor.

The determination is a mixed question of law and fact. The Court analyzed the 13 factors involved in recharacterization and applied these factors to determine that the Bronze Group loan would not be recharacterized. The court applied the three categories of misconduct for equitable subordination: (1) fraud, illegality, breach of fiduciary duty; (2) undercapitalization and (3) use of the debtor as a mere instrumentality or alter ego, and determined that the Bronze Group's preference for structuring the funds advanced to the debtor as a loan rather than an equity investment was not inherently inequitable.

10TH CIRCUIT BAP OPINIONS

***In re Campbell*, BAP No. WY-03-057 (10th Cir. BAP August 16, 2004)**. The 10th circuit BAP held that the bankruptcy court did not have jurisdiction to enter an order denying the debtor's claim of a homestead exemption in a Chapter 13 case. The debtor claimed an exemption in property in which she had an equitable interest under an option to purchase. The Chapter 13 Trustee objected to the exemption. The debtor argued that the objection to the exemption was moot because the confirmed Chapter 13 plan provided that the debtor was revested of all property of the estate.

The Bankruptcy Court held that the objection was not moot because if the case were converted to Chapter 7, the Chapter 7 trustee would be time-barred under Bankruptcy Rule 4003(b) from objecting to the homestead exemption.

The BAP held that the bankruptcy court erred in determining that the 30-day objection period under Bankruptcy Rule 4003(b) would not recommence in the event the Chapter 13 case was converted to Chapter 7. In so holding, it adopted the minority view that the conversion of a case from chapter 13 to chapter 7 under §348(a) constitutes an order for relief, occasioning a new meeting of creditors in the converted case, and commencing a new 30-day period for objection to exemptions.

Because the dispute did not impact the Chapter 13 case, the bankruptcy court lacked jurisdiction of the objection to the exemption because there was no "case or controversy" in the Chapter 13 case.

***In re Davis*, BAP No. 04-029 (10th Circuit BAP August 26, 2004)**. Following the holding of the Supreme Court in Farrey v. Sanderfoot, 500 U.S. 291 (1991), the BAP affirmed a bankruptcy court determination that a domestic court-awarded lien on a spouse's homestead was not an avoidable judicial lien under §522(f)(1)(A).

The Oklahoma state court found that the marital homestead was joint property subject to equitable distribution by the court in the divorce case, and entered a decree simultaneously awarding title to the residence to the husband, and granting a lien in favor of the wife to secure payment of a property settlement representing her share of the equity in the house. Under the logic of Farrey, the bankruptcy court found that the lien attached to the property before it was awarded to the husband, and that the lien could not be avoided under §522(f)(1)(A).

***In re Campbell,* BAP No. EO-04-034 (10th Circuit BAP August 27, 2004).** Chapter 12 of the Bankruptcy Code was passed as an emergency remedy in 1986 and was set to expire on October 1, 1993. The expiration date was continuously extended. Chapter 12 expired on July 1, 2003, but was reinstated retroactively on August 15, 2003 as of July 1, 2003, and then finally expired on January 1, 2004.

The debtors filed a chapter 13 petition and plan on August 4, 2003. Even though the debtors are ranchers, they could not have filed a Chapter 12 on August 4, 2003 because Chapter 12 had expired at that point. The Chapter 13 Trustee moved to dismiss for failure to provide documents, and the Farm Service Agency also moved to dismiss on eligibility grounds. On September 18, 2003, the debtors moved to convert the case to Chapter 12.

The bankruptcy court scheduled the debtors' conversion motion for hearing on January 8, 2004, and orally granted the motion at the conclusion of the hearing. However, it later entered an order denying the motion because of the expiration of chapter 12 on January 1, 2004, ruling that it had no authority on January 8, 2004 to convert the case to chapter 12.

The BAP reversed, holding that the debtors were eligible for Chapter 12 relief on the day they filed their chapter 13 petition in August 2003 because of the language of Title I of Division C of Pub. L. No 105-277: "The substantive rights of parties in connection with such cases, matters and proceedings shall continue to be governed under the law applicable to such cases, matters and proceedings as if such chapter were continued in effect after January 1, 2004."

Thus, the law applicable on the petition date, not the conversion date, applies to determine whether Chapter 12 relief is available. Therefore, the bankruptcy court had jurisdiction to convert the chapter 13 case to chapter 12.

***In re Busetta-Silvia,* BAP No. NM-03-087 (10th Circuit BAP September 8, 2004).** In a case of first impression in the 10th Circuit, the BAP reversed a bankruptcy court ruling that services of Chapter 13 counsel performed prepetition must be paid in full prior to the filing of the case or be treated a a prepetition unsecured claim.

Chapter 13 counsel filed a fee application requesting compensation for services to the debtor and reimbursement of costs as an administrative expense, including prepetition fees. The bankruptcy court disallowed the prepetition fees as an administrative expense and allowed them as a general unsecured claim to be paid pro rata with claims of other unsecured prepetition creditors under the chapter 13 plan. The bankruptcy court found no express authorization in 11 U.S.C. §§330 or 507 to treat prepetition fees as an administrative expense, and cited the fundamental distinction between prepetition and postpetition assets and liabilities to deny the administrative expense claim.

The BAP read §§330(a) and 501(a)(1) together to conclude that an attorney fee awarded under §330(a) is entitled to first priority and must be paid in full under the terms of a Chapter 13 plan. The unambiguous language of §330(a)(4)(B) which refers to services rendered "in connection with the bankruptcy case" places no restriction upon the timing of the services, and does not require the services to have been performed after the filing of the bankruptcy petition.

The BAP specifically limited its holding to Chapter 13 cases and offered "no pronouncement upon the issue of administrative priority of attorney's fees for debtor's counsel in Chapter 7 cases".

U.S. DISTRICT COURT CASES

Expeditors International of Washington, Inc. v. The Liquidating Trust (In re Schwinn Cycling and Fitness, Inc.), **Civil Action No. 03-N-1823 (D. Colo. August 6, 2004).**

Expeditors had a prepetition security interest in goods, perfected by possession. When Expeditors gave possession of the goods to the debtor, its security interest was temporarily perfected under C.R.S. §4-9-312(f) which provides for a twenty-day period of automatic perfection where goods are made available to the debtor for several purposes, including sale. At the conclusion of the twenty-day period, the UCC requires perfection in some other way provided by the UCC. Expeditors did not reperfect its security interest by filing a financing statement or any other method provided by the UCC.

However, a Stipulation and Order was entered in the bankruptcy case under which the debtor established a segregated cash collateral fund upon which Expeditors held a replacement lien to the extent its security interest in the goods and proceeds was valid and enforceable.

Expeditors filed a complaint seeking a determination as to the validity, priority and extent of its lien on the goods and their proceeds. The bankruptcy court determined that the security interest in the goods lapsed when it was not reperfected after the twenty-day period expired. Expeditors argued that the filing of the Chapter 11 bankruptcy case rendered the security interest permanent perfected. However, the case of In re Reliance Equities, Inc., 966 F.2d 1338, 1341-45 (10th Cir. 1992) controlled. In that case, the 10th Circuit cited one of the principal purposes of the Bankruptcy Act to strike down secret liens, and found that the version of the UCC then in effect in Colorado made no mention of an extension of automatic perfection in the event of the commencement of insolvency proceedings. The holding of the bankruptcy court that Expeditors lost its perfected status in the goods when it failed to file a financing statement was upheld.

With respect to the proceeds, the 10th Circuit defined the issue as whether the proceeds were "identifiable cash proceeds" pursuant to C.R.S. §4-9-315. If the security interest in the original collateral was perfected, even temporarily, the security interest in "identifiable cash proceeds" is perfected indefinitely. The 10th circuit remanded the case to determine this factual issue as to the proceeds.